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Municipal-Debt Fans: 'We've Been Waiting For a Market Like This'

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There aren't many places to hide in today's tempestuous markets. Stocks took a beating late last week; Treasury bonds offer skimpy yields, and corporate debt looks vulnerable to recession.

Municipal bonds have suffered losses, too, but there veteran investors are strongly bullish, saying they have little doubt they see the greatest buying opportunity of their careers.

Municipal debt generally pays out interest that is 10% to 20% less than comparable U.S. Treasurys because holders don't pay federal taxes on the interest income. Friday, top-rated 30-year municipal debt was yielding about 16% more than 30-year Treasurys, and two-year municipal notes were paying out 60% more than comparable Treasurys.

When the tax benefits are taken into account, the result is eye-popping yields. At an average yield of 5.14% on triple-A-rated 30-year municipal bonds, a California resident in the top federal income-tax bracket earns the equivalent of 8.72%.

Shelia Amoroso, a portfolio manager at Franklin Templeton Investments, says she has never seen anything like this in her 21 years in the market. "It's a compelling buying opportunity."

Hugh McGuirk, head of the municipal-bond division at T. Rowe Price Group Inc., Friday bought bonds issued by the state of Florida yielding 5.85%. Two weeks ago they were at 5%. "We've been waiting for a market like this."

This puts the municipal market in the odd place of competition with struggling stocks. "Munis are offering a risk-adjusted return that probably exceeds equities under more normal circumstances," Cumberland Advisors said in a weekend market update.

Of course, the selling that has led today's high yields has meant paper losses for current muni holders, and there is no guarantee that will end right away. The average long-term national municipal-bond fund is down 3.83% this year, according to Morningstar Inc. Short-term national municipal funds are down 0.18%.

Still, many fund managers are speaking with a sense of conviction about municipal bonds that is hard to find on Wall Street these days. Stock prices might be cheap compared with their earnings potential, but considerable uncertainties about the economy and corporate profits are keeping many stock investors on the sidelines. Those that are buying are doing so in small doses. Friday's

selloff in stocks, with the Dow Jones Industrial Average falling 2.5%, was a reminder why many remain cautious.

It is a similar story elsewhere in the bond market. Yields on high-yield corporate debt have shot higher, but many fund managers are steering clear amid worries that corporate defaults could rise substantially in the wake of the credit crunch and slowing economy.

Municipal debt has been offering richer-than-normal yields compared with Treasuries since late last year. Only in the past week have they shot up significantly. Behind the move: forced selling by hedge funds and other traders as they unwound complex bets gone wrong.

Although municipal debt historically is the domain of individual investors, in recent years hedge funds had flocked to a trading strategy that hinged on the normally reliable wide gap between yields on short-term and long-term municipal securities.

The hedge funds sought to profit from that gap by borrowing at the lower short-term rates, buying longer-term higher-rate municipal debt and pocketing the difference. They magnified this trade by borrowing heavily to make this bet, sometimes using 10 times debt for every dollar of investor money they were putting to work. At times they also layered on bets against U.S. Treasury securities.

The strategies have gone haywire lately, with both Treasury yields and municipal-bond yields going against these trends -- with Treasuries strengthening and municipal debt weakening. One problem: many municipal bonds are guaranteed by bond insurers such as Ambac Financial Group Inc. and MBIA Inc., which in turn enable those offerings to receive the highest credit rankings from rating providers. The bond insurers have run into trouble because of their exposure to risky-mortgage debt. Investors in turn became worried the municipal-bond guarantees would suffer, hurting municipal bonds and sending their yields higher.

Default rates on municipal bonds tend to be low, even without the bond-insurer guarantees, which fund managers say is part of their allure. Standard & Poor's says municipal debt carrying a triple-B rating -- three rungs down from the top -- has a long-term default rate of about 0.32% of outstanding bonds. That is lower even than the 0.6% default rate on triple-A-rated corporate bonds.

Of course, there still are risks to holding this debt. More forced selling could ensue by funds that own municipal debt, sending prices lower still.

A number of players said they also are looking at an area known as "pre-refunded" municipal debt, in which interest payments are effectively guaranteed by a pool of U.S. Treasuries or other government securities held in an escrow account.

Late Friday, the average 5-year pre-refunded bond yielded 3.23%, compared with 2.47% on a five-year Treasury. Throw in the tax benefit, and for a New Jersey resident, the pre-refunded debt pays the equivalent of a 5.31% yield on Treasuries. George Goncalves, an interest-rate strategist at Morgan Stanley, calls it "the dislocation of a lifetime." The market, he says, "has thrown out the good with the bad."